



May 12, 2008

AGENDA ITEM 3

TO: MEMBERS OF THE INVESTMENT COMMITTEE

- I. SUBJECT:** Policy Subcommittee Report
- II. PROGRAM:** Total Fund
- III. RECOMMENDATION:**
- a. Total Fund - Revision of Policy on Asset Allocation Strategy
 - b. Global Equity – Revision of Policy on Internally Managed Global Equity Index Funds
 - c. Policy Review and Consolidation Project – Revision of Global Fixed Income Policies:
 - 1) Adoption of Policy on Global Fixed Income Program (consolidation of Dollar-Denominated Fixed Income and Externally Managed Active International Fixed Income Programs)
 - 2) Adoption of Policy on Low Duration Fixed Income Program (consolidation of Dollar-Denominated Fixed Income Limited Duration and Dollar-Denominated Fixed Income Short-Term Internally Managed Programs)
 - 3) Revision of Policy on Lehman Aggregate Program
 - 4) Revision of Policy on Treasury Inflation Protected Securities Program
 - 5) Revision of Policy on Currency Overlay Program

IV. ANALYSIS:

Background

The Policy Subcommittee met on April 21, 2008. The Subcommittee reviewed proposed revisions to Total Fund and Global Equity policies. In addition, the Subcommittee reviewed proposed revisions to Global Fixed Income Policies, as part of the Policy Review and Consolidation Project.

The proposed revised policies are attached. Unless otherwise noted, they are presented as black-lined versions from the last adopted policy by the Investment Committee. The black-line uses strike-out to indicate deletions and double underline to indicate additions. Single underline does not indicate a change; rather, it indicates that the term is defined in the glossary.

a. Revision of Policy on Asset Allocation Strategy

Staff recommended the following five changes:

1. Asset Class Policy Targets and Ranges – The proposed policy identifies the target, permissible range and benchmark for each asset class.
2. Treatment of Cash – Cash holdings may be retained as cash or converted to bond or equity exposure.
3. External Managers – External managers may be hired to implement active asset allocation strategies within specified tracking error limits.
4. Tracking Error Targets – The revised policy now contains a 1.5% target tracking error for the CalPERS total fund and a 0.75% target tracking error for the active asset allocation program.
5. Derivatives – The proposed policy limits the exposure to counterparties on non-exchange traded positions and establishes counterparty credit quality and regulatory standards.

The Subcommittee recommends approval of the revised policy.

b. Revision of Policy on Internally Managed Global Equity Index Funds

The Investment Committee approved two new internally managed index portfolios at the March 17, 2008 meeting. These portfolios provide

exposure to international developed markets small and micro capitalization securities and to emerging market equities.

The revisions to this policy incorporate these two new portfolios by the addition of relevant language to Section IV (Performance Objective and Benchmark).

The Subcommittee recommends approval of the revised policy.

c. **POLICY REVIEW AND CONSOLIDATION PROJECT – GLOBAL FIXED INCOME POLICIES**

The objectives of the Policy Review Project are (1) to organize and streamline Investment Policy to improve access, clarity and transparency, (2) to provide a consistent Investment Policy framework, and (3) to ensure that the policies will facilitate the on-going CalPERS compliance program.

The Policy Review Project entails a detailed review of each policy with the goal of updating and streamlining the policy, as well as potential consolidation with other related policies. In addition to these goals, the review and revisions include the following:

- Removal of delegations from policy. During the Delegations Project, staff reviewed all policies, minutes, and delegations to identify and consolidate delegations. Delegations are now located in consolidated documents.
- Removal of operational and procedural language, which is now located in staff internal procedure manuals.
- Conformance to the new template.

The review is a joint effort and includes input from the General Pension Consultant, the CalPERS Legal Office, and the Enterprise Office of Compliance.

At the April 21, 2008 meeting, Staff presented the proposed consolidation of and revisions to the Global Fixed Income policies. Clean versions are provided for each policy. Black-line versions of each policy were provided in the April 21, 2008 Policy Subcommittee agenda materials. As a general rule, the revised policies have not been changed substantively. Any substantive changes are explained below.

1) Global Fixed Income Program

The adoption of the Global Fixed Income Program policy consolidates the Dollar-Denominated Fixed Income Program ("Domestic Program") and the Externally Managed Active International Fixed Income Program ("International Program").

Staff proposed two changes to the consolidated policy:

- a. Add investment grade preferred stock to the list of Authorized Securities for the Domestic Program (Section II.B.9).
- b. Convert the International Program's Interest Rate Risk to a percentage (Section II.B.2). This revision was made for consistency since other Global Fixed Income policies state Interest Rate Risk as a percentage.

2) Low Duration Fixed Income Program

The adoption of the Low Duration Policy consolidates the Dollar-Denominated Fixed Income – Limited Duration Program ("LD Program") and the Internally Managed Dollar-Denominated Fixed Income Short-Term Program ("ST Program").

One substantive change was made to both the LD and ST Programs. Both Programs will allow stock repurchase agreements. This revision was made for consistency, because the Securities Lending Policy currently allows stock repurchase agreements.

3) Lehman Aggregate Program

The Lehman Aggregate Program ("LA Program") is a mirror image of the Domestic Program except the benchmark is the Lehman Aggregate Index (LAI) instead of the Lehman Long Liabilities (LLL) Index.

Staff proposed three revisions to the Lehman Aggregate Program:

- a. Change the policy name from Self-Funded Healthcare to the Lehman Aggregate Program. The Lehman Aggregate Program is the vehicle used to invest Self-Funded Healthcare and Supplemental Income Plan monies.

- b. Raise the non-investment grade percentage from 10% to 20% to be consistent with the Domestic Program.
 - c. Add investment grade preferred stock to the list of Authorized Securities for the LA Program (Section V.D.8).
- 4) Treasury Inflation Protected Securities Program

No substantive changes were made.

5) Currency Overlay Program

Staff proposed three modifications which will either clarify the Currency Overlay Program Policy or create greater consistency across Global Fixed Income policies.

- a. Additional language has been inserted in Attachment A, Section 1 to clarify the measurement of the program objectives.
- b. Attachment A, Section II.A was revised to clarify and create flexibility for the selection of the Currency Committee.
- c. Attachment C, Section I was amended to allow for the passive reduction of currency risk for program and assets beyond International Equity.

The Subcommittee recommends approval of the policies listed above.

The following Global Fixed Income policies have been recently approved by the Investment Committee. All of these policies conform to the new template format. These policies were not presented for Subcommittee action.

Policy Name	Approval Date
Credit Enhancement Program	November 13, 2007
Securities Lending	November 13, 2007

V. STRATEGIC PLAN:

This item supports Goal VIII: Manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize contributions.

VI. RESULTS/COSTS:

The results of this item will provide CalPERS with enhanced efficiencies and ability to manage the overall portfolio. The revised policies will provide a foundation for compliance, accountability, and transparency.

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